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REVIEW OF THE DEPARTMENT OF THE TREASURY'S SECOND ANNUAL REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE SECOND ANNUAL REPORT SUBMITTED TO CONGRESS BY THE TREASURY PURSUANT TO THE REQUIREMENT CONTAINED IN THE 1988 OMNIBUS TRADE BILL. THE PURPOSE OF THE PROVISION IN THAT LEGISLATION WAS TO INSTITUTIONALIZE AN ONGOING REPORTING AND CONSULTATION PROCESS BETWEEN THE ADMINISTRATION AND THE CONGRESS

NOVEMBER 16, 1989

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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REVIEW OF THE TREASURY DEPARTMENT'S SECOND ANNUAL REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

THURSDAY, NOVEMBER 16, 1989

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, DC.

The committee met at 10:03 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

Present: Senators Sarbanes and Heinz.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The committee will come to order.

I apologize to the witness and others for our delay in starting, but anyone who has tried to make it through the streets this morning I think has some understanding of the problem.

Today the Subcommittee on International Finance and Monetary Policy holds a hearing to review the Treasury's report on international economic and exchange rate policy. This is the second annual report submitted to Congress by the Treasury pursuant to the requirement contained in last year's omnibus trade bill.

The purpose of the provision in that legislation was to institutionalize an ongoing reporting and consultation process between the Administration and the Congress on the conduct of international economic and exchange rate policy, and I simply want to say from my perspective I think that this consultation process has proceeded in a very positive way and we are particularly pleased that Secretary Mulford is here with us this morning.

The impetus for the requirement that was in the trade bill for such reporting and consultation came from the experience we had earlier in the decade when the value of the dollar was permitted to reach and remain at a very high level for an extended period of time, with no policy focus and with severe consequences for the U.S. balance of trade. The reports required by the legislation, which we will be addressing this morning, are intended to ensure that Congress is kept closely informed on the conduct of policy affecting the dollar.

Thus far, these reports, updated every 6 months by the Treasury, seem to be serving their purpose very well.

Today's report is being submitted at a time when U.S. policy on exchange rates and international economic coordination faces sig-

nificant challenges. The value of the dollar has gradually appreciated in 1988 and 1989 following a significant decline, from 1985 to 1987.

While the United States has experienced improvements in our balance of trade over the past 2 years, that may in large part be attributable to the positive effects of the decline in the dollar that took place prior to last year.

In fact, the report we are receiving this morning points out that external adjustment has slowed in 1989 and there are considerable uncertainties as to the prospects for continued adjustment in 1990.

Such an outlook raises important questions for the conduct of U.S. international monetary policy. While the finance ministers and central bank governors of the G–7 countries in a statement issued after their meeting in September agreed that a rise in the dollar above current levels could adversely affect prospects for the world economy and agreed to cooperate closely in the exchange markets, the question remains whether significant progress can be made in reducing the U.S. trade deficit if the dollar remains at present levels.

The subcommittee will also look forward this morning to a discussion of the status of negotiations with the countries that have been designated by the Treasury, pursuant to the requirements of the trade bill, as manipulating the rate of exchange between their currencies and the dollar to gain unfair competitiveness in international trade.

We are very pleased to have with us this morning to present the report and to comment on international economic and exchange rate policy David Mulford, the Undersecretary of the Treasury for International Affairs, and following Secretary Mulford we will hear from the Vice Chairman of the Board of Governors of the Federal Reserve System, Manual Johnson.

David, we are pleased to have you here. We are looking forward to hearing from you.

STATEMENT OF DAVID C. MULFORD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. MULFORD. Thank you, Mr. Chairman. It is a great pleasure to be here this morning and to have this opportunity to report on international economic and exchange rate policy.

Before beginning my remarks, Mr. Chairman, I would like to thank you for holding these hearings and for the support in general this committee has provided on a wide range of international economic policy issues.

I would like this morning not to read my full statement, instead to submit it for the record and instead to make some very brief remarks summarizing the high points of the statement.

Senator SARBANES. Fine.

Mr. MULFORD. First, I think it is important to note that the coordination process is contributing importantly to the current economic success achieved by major industrial countries over these past 7 years and, in particular, over the past 3 years.

In 1988, we enjoyed strong economic growth, despite the October 1987 stock market decline, and a substantial $32 billion reduction in the U.S. trade deficit. Meanwhile, during 1988, inflation was contained effectively.

So far this year there has been further adjustment of external imbalances taking place, but of course at a somewhat reduced pace. We expect further improvement this year of $10 billion to $15 billion in our trade deficit. Any further improvement in the U.S. current account position during 1990, however, we think will be modest, and there is some possibility of a deterioration in that number.

I would note, however, this morning that the trade figures that were reported this morning at 8:30 were very positive. For September the trade deficit was reported at $7.94 billion and the August figure was adjusted downwards from $10.7 billion to $10.1 billion. The September figure is the lowest figure we have seen since December of 1984.

Of course, I wouldn't read too much into 1 month of figures, whether they are either bad or good, but I think it is interesting to note that the adjustment process continues, particularly because in these figures exports were up strongly and imports were down fairly sharply.

We expect a moderate growth of 3.5 percent for the G–7 countries in 1989, and we project the current expansion to continue into next year. Inflation has been a bit higher due to temporary factors, but recently these pressures seem to have been reduced.

Our top priorities are to maintain vigilance on inflation, to sustain economic growth, and to reduce external imbalances. Adjustment requires action by surplus and deficit countries alike. For the United States the top priority is to make further progress in reducing our budget deficit, and while important progress has been made on that, we now are getting to the hard bedrock of really difficult choices in the budget reduction process.

Surplus countries need to do their part. Japan's strong domestic demand growth has been helpful, but it must continue. Germany is experiencing strong growth, but the composition of that growth has not really been consistent with adjustment. However, I think it is fair to say that developments in Eastern Europe at this time may in fact over time have some positive effects on the German adjustment effort.

All countries must implement structural reforms, which of course are very difficult to negotiate because they involve domestic political issues and longstanding practices.

We recognize that the appreciation of the dollar in 1989 has been counterproductive for the adjustment effort. The G–7 has been cooperating on an intensified basis and progress has been made in exchange markets and related economic policies.

Since the G–7 meeting September 23rd, exchange markets have been relatively stable. The dollar is nearly 8 percent below its mid-September highs with respect to the deutsche mark and approximately 4 percent below the same highs with respect to the yen.

On Taiwan and Korea, Mr. Chairman, let me just make a couple of points there.

Our exchange rate negotiations with Taiwan and Korea have in fact achieved progress in recent months. The new Taiwan dollar has appreciated significantly since our October 1988 report, largely due to implementation of a more market based system of exchange rate determination in Taiwan. There have been no clear indications of exchange rate manipulations since our last report.

Reduction of Taiwan's external surpluses, however, appears at this point to have stalled, and we will monitor the situation closely to ensure that exchange rate policy supports continued reduction in Taiwan.

Exchange rate appreciation in Korea has consistently been more difficult to achieve, and Korea's exchange rate determination system remains inherently manipulative.

While Korea's global trade and current account surpluses as well as our own bilateral trade deficit have fallen significantly so far this year, the imbalances do remain large. It is not clear at this time whether the decline will continue next year.

Our negotiations with Korea in the period ahead will be directed at ensuring that exchange rate policy is consistent with the continued decline of Korea's external surpluses, and, of course, we will also press for liberalization of the exchange rate determination system.

Those are my preliminary remarks, Mr. Chairman. I would be happy to answer any questions.

[The complete prepared statement of David C. Mulford follows:]

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STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
UNITED STATES SENATE
NOVEMBER 16, 1989

Mr. Chairman and members of the Committee:

It is a great pleasure to be here today and to have this opportunity to discuss with you the Department of the Treasury's report on international economic and exchange rate policy. This report and the consultations with Congress on U.S. international economic policy have in a very short time proven to be a highly effective and important element in broadening understanding of the relationship of U.S. domestic and external policies and advancing U.S. international economic objectives. We look forward to continuing and broadening this dialogue.

I would like to focus my remarks on two aspects of U.S. international economic policy. First, the economic policy coordination process and our efforts to promote sustained growth with low inflation and reduce external imbalances. Second, our negotiations to achieve exchange rate appreciation and market-oriented policies in Korea and Taiwan, consistent with their sizable external surpluses and growing international responsibilities in the world economy.

Economic Policy Coordination

The economic policy coordination process has contributed importantly to the record of success achieved by the major countries in recent years. This process has provided a framework in which the Finance Ministers and Central Bank Governors of the G-7 countries can collectively review their economic policies and prospects, establish objectives, and assess the need for changes in policies.

The major countries have achieved 7 consecutive years of sustained expansion. At the same time, inflation and interest rates have been substantially reduced. World trade growth has been strong, facilitating external adjustment. The major countries have put into place policies to rein in public spending, reform tax systems, liberalize financial markets and dismantle excessive regulations and red-tape.

The efforts undertaken in 1987 resulted in a solid performance for the world economy last year, despite the fears arising from the stock market decline in October 1987. The G-7 countries experienced vibrant growth well in excess of expectations. The U.S. trade deficit was reduced by a substantial $32 billion. The success of 1988 is being carried forward this year.

In 1989, further adjustment of external imbalances is taking place, although at a reduced pace. Strong export growth is continuing in the United States this year, and developments to date point to further reduction of our trade deficit on the order of $10 to 15 billion to the $110 to 115 billion range. We expect solid, moderate economic growth in the range of 3-1/2 percent in the G-7 countries and the current expansion should continue next year. Inflation is likely to be about 1-1/2 percentage points higher on average this year, largely due to the run-up in commodity prices in late 1988 and early 1989. Significantly, however, concerns earlier this year about an intensification of price pressures have receded as the G-7 have responded with the implementation of appropriate policies.

Despite this progress, we have not become complacent. We remain vigilant in containing inflation. We are concerned about the slowing of the external adjustment process. Sustaining the expansion and reducing external imbalances will continue to be our priorities. This will require further efforts by deficit and surplus countries.

For the United States, this means continuing our efforts to reduce the Federal budget deficit by implementing measures to achieve the Gramm-Rudman-Hollings targets. Progress has been made in deficit reduction. From a peak of over 6 percent as a share of GNP in FY 1983, the deficit has been brought down to an anticipated 2 percent of GNP in FY 1990. Combining Federal, state, and local governments, our deficit is projected to be 1 percent of GNP in FY 1990. Now we are at the hardest part in deficit reduction, where difficult choices must be made. The success of this effort is crucial to improving national savings and our external deficit. We must also take other measures to strengthen private savings and reduce reliance on foreign funds to finance domestic investment.

The efforts of the G-7 to maintain global growth and adjust external imbalances is a shared responsibility. Japan and Germany must put in place policies to reduce substantially their large external surpluses by achieving a level of domestic demand growth

over the medium term which exceeds by a sufficient margin output growth. Japan has experienced the strongest growth of the G-7 countries in recent years and its current account surplus as a share of GNP has declined to the 2-1/2 percent range. Germany has also experienced strong growth but its composition has not been consistent with external adjustment requirements. Thus, imports have not increased sufficiently to offset export growth, and the trade surplus has grown substantially. As a result, the current account surplus remains at a record high, equivalent to over 4 percent of GNP.

The exchange rate adjustments and changes in relative growth rates are necessary but not sufficient conditions for achieving adequate external adjustment. All countries must also implement structural reforms to promote greater economic efficiency, such as opening their economies to foreign goods and services, curbing subsidies and burdensome regulations, and fostering savings where they are inadequate. Such reforms are difficult to negotiate, involving complex domestic political issues and longstanding practices that have become ingrained in our societies. Nevertheless, they must be addressed.

Exchange rates are one of the many factors that affect economic performance and prospects and are thus reviewed within the broader framework of the economic policy coordination process. At their recent meeting, the G-7 Finance Ministers and Central Bank Governors stated that the rise of the dollar in recent months was inconsistent with longer run fundamentals. They agreed that a rise of the dollar above levels prevailing at the time or an excessive decline could adversely affect prospects for the world economy. The G-7 have been cooperating on an intensified basis and progress has been made in exchange markets and in related economic policies. Exchange markets have been relatively stable since the September 23 meeting, and the dollar is now nearly 8 percent below its mid-September highs with respect to the mark and nearly 4 percent with respect to the yen. We will continue to work closely together.

Asian Newly Industrialized Economies

Responsibility for the adjustment of global external imbalances does not lie only with the largest countries. The newly industrialized economies of Asia are playing an increasingly important role in the world economy in recent years as their own economies grow and their share of world trade expands. The interest that they share in preserving the world trading system and the sizable external surpluses that some of these economies are enjoying confer an obligation on them to assume a greater responsibility for contributing to the reduction of the world's external imbalances and promoting a sound and growing world economy.

The Omnibus Trade and Competitiveness Act of 1988 recognized that undervalued currencies can be unfairly exploited to build up sizable external surpluses. The Treasury Department concluded in its October 1988 report on International Economic and Exchange Rate Policy that Korea and Taiwan "manipulated" their exchange rates within the meaning of the legislation. Pursuant to these findings, we initiated bilateral negotiations, on an expedited basis, with these two economies in late 1988. We reaffirmed our assessment in our April 1989 report and have continued our negotiations since then.

We have achieved progress in these negotiations. The Korean and Taiwanese currencies have both appreciated since the October 1988 report. Reflecting this appreciation and certain other factors, the external surpluses of both economies have declined. We still have concerns, however, which I will discuss in the remainder of my testimony.

Since the October 1988 report, the New Taiwan dollar has strengthened by over 12 percent against the U.S. dollar. More than 5 percentage points of this movement came shortly after the release of the April report. In the last 5 months, the New Taiwan dollar has been fairly stable.

The cumulative appreciation of the New Taiwan dollar has contributed to a decline in Taiwan's external surpluses. Taiwan's global current account surplus fell by 43 percent last year to $10.1 billion. The U.S trade deficit with Taiwan decreased by 27 percent in 1988 to $12.6 billion. Half of this reduction, however, was due to extraordinary purchases of $2.5 billion of gold from the United States by Taiwan's Central Bank.

Taiwan's current account deficit is expected to fall further in 1989, although by a modest amount. Because Taiwan's one-time gold purchases have been completed, our trade statistics show an increase in our trade deficit with Taiwan of 13 percent in the first 8 months of 1989. If we exclude the effect of Taiwan's 1988 gold purchases and compare 1988 and 1989 trade on a non-gold basis, we see continued modest improvement. Our non-gold trade deficit with Taiwan in the first 8 months of this year is 14.5 percent lower than in the same period last year.

Following our bilateral negotiations early this year, Taiwan instituted a new and liberalized exchange rate system in April. As Secretary Brady and I mentioned in testimony before Congressional Committees last May, we viewed this step as a constructive move toward a more market-oriented system. We noted several operational problems, however, that caused us to question how effective the new system would be in reducing "manipulation."

Since our testimony last May, the Taiwanese authorities have taken a number of steps to allow greater play for market forces in the new exchange rate determination system and also to reduce capital controls. Most importantly, there is no evidence that the Central Bank continues to intervene substantially in the market, as it has in the past.

In view of these developments, I am pleased to be able to report to you that there are no clear indications that Taiwan is still "manipulating" the exchange rate for competitive advantage. Given the slowdown in the pace of improvement in Taiwan's external surpluses, however, the authorities need to recognize the continued importance of the exchange rate in furthering the adjustment process. We will continue to monitor the situation closely.

Exchange rate appreciation has been consistently more difficult to achieve in Korea. Significant improvement was not forthcoming until 1988. Thus, the correction of Korea's external surpluses was also delayed and did not begin until this year.

Between the beginning of 1988 and the release of the October 1988 report, the Korean won appreciated by almost 12 percent against the U.S. dollar. In the remainder of 1988, the won strengthened by another 4 percent. Because the U.S. dollar itself strengthened against other major currencies in 1988, the won appreciated by even more against non-dollar currencies such as the yen. This is a significant development, because it meant that for the first time, Korea began to lose some of the competiveness that it had established earlier.

In 1989, the won has appreciated by less than 2 percent against the U.S. dollar, but again because the dollar has strengthened against other major currencies in 1989, the won has appreciated more relative to the non-dollar currencies. Since the end of April, however, the authorities have depreciated the won slightly due to their concern about Korea's declining surpluses.

Korea has made considerable progress so far this year in reducing its external surpluses. In the first 8 months of 1989, Korea's current account surplus fell to $2.7 billion. This is a 66 percent drop, compared to the same period last year. Also, our trade imbalance with Korea declined by 25 percent through August to $4.2 billion. On a quarterly basis, our bilateral trade deficit with Korea has been declining fairly steadily since the beginning of 1988.

These welcome declines reflect a number of factors. The won's past currency appreciation, including against the non-dollar currencies, is a principal cause. The sizable increase in imports due to large wage increases and Korea's on-going trade liberalization program is of major significance. Severe labor-management disputes also played an important role in restraining Korea's export growth this year.

It is not clear, however, that these factors will contribute to continued declines in Korea's external surpluses, which still remain large as a percentage of Korea's GNP. Indeed, the recent depreciation of the won and press reports that export promotion programs will be reinstated could be interpreted as a desire on the part of the Korean authorities for larger external surpluses. Further appreciation may be required to ensure that the decline in the external surpluses continues next year.

In addition, unlike Taiwan, Korea has not made progress on the fundamental task of reforming its exchange rate determination system. This system continues to be characterized by comprehensive controls, a lack of a role for market forces, and thus, remains "manipulative" by its very nature. In this regard, I would like to note that Korea's Ministry of Finance has recently agreed to commence talks with Treasury on financial policies and markets. We hope to make progress in those talks on the fundamental issue of Korea's exchange rate determination system.

In sum, Korea presents a mixed picture. We welcome the significant decline that has occurred in Korea's external surpluses so far this year. Yet, exchange rate developments in the past 6 months have not been fully satisfactory in view of questions as to whether Korea's surpluses will continue to decline next year. Moreover, market forces still do not have a role in exchange rate determination. Thus, on balance, our judgment is that there have continued to be indications of exchange rate "manipulation" during the 6 months since the April report.

In our negotiations with Korea in the period ahead, as well as within the framework of our new dialogue on financial policy issues, we will continue to press for exchange rate policy to support further, lasting external adjustment and urge liberalization of the exchange rate system.

Conclusion

The United States is committed to cooperating with its major trading partners to promote the sound world economy and stable financial system on which all countries' prosperity rests. The success of this effort will also require that the Executive Branch and the Congress work closely to deal with difficult domestic issues. The dialogue we have begun on the international aspects of U.S. economic and exchange rate policies is an important element in this effort. The Treasury Department looks forward to extending and broadening this dialogue in the weeks and months ahead.

Thank you, Mr. Chairman.

Senator SARBANES. Well, thank you very much, Mr. Secretary. As I indicated earlier, we are pleased to have you back before the committee.

I wanted to focus on your report, if you have it there with you.

Mr. MULFORD. OK.

Senator SARBANES. On page 17. As I understand it, since the April report, when we had this, as it were, dual focus on Taiwan and Korea, Taiwan's exchange rate has appreciated against the dollar while Korea's has actually depreciated slightly, is that correct?

Mr. MULFORD. That is correct. Korea's exchange rate in recent times has depreciated slightly.

Senator SARBANES. Furthermore, I note at the end of the first paragraph there you point out that since the Plaza Agreement in September of 1985, which is, in my perception at least, when the Treasury finally and first began to address this problem of an overvalued U.S. dollar, the yen has strengthened 70 percent against the dollar, the new Taiwan dollar strengthened 58 percent, the German mark 54 percent, but the Korean won only 33 percent; in other words, half of Japan and some—maybe about 60 percent of what the others have done.

Is that correct?

Mr. MULFORD. That is correct. Those numbers are correct.

Senator SARBANES. Now, you say later in your report on page 29:

> Recently, the Treasury Department and the Korean Ministry of Finance have agreed to initiate talks on financial policies, including the exchange rate system and capital market issues.

How recently was that agreement to begin talks arrived at?

Mr. MULFORD. Well, we have had talks going on with the Koreans since the summer of 1986 on the exchange rate question. They have been periodic, informal contacts whenever we have had the opportunity either to be in Korea or they have been here, and they have produced some results. The talks that you are referring to are more formal talks that are aimed at financial markets in general, rather like the so-called yen/dollar talks that we started with the Japanese in 1984.

Up until recently the Koreans were not willing to engage in broad, formal talks on financial markets, financial market liberalization, including exchange rate questions, but recently—as a matter of fact, I believe it was in September, late September—they agreed in principle that they would be willing to engage in those sorts of talks and we expect those talks to begin in the new year.

Senator SARBANES. Well, this is a matter of very deep concern. I know that some of my colleagues wrote to Carla Hills, the U.S. Trade Representative, with respect to negotiations over steel and expressed their concern about the trade distorting impact of artificial currency manipulation employed by major U.S. trading partners, and although currency manipulation is not recognized as a subsidy under U.S. trade law, the United States cannot ignore the critical impact of this practice in upcoming negotiations on steel, and they focused on the currency manipulation by the government of Korea and asked her to take this manipulation into account in the course of working on the steel consensus negotiations.

She responded that while that issue was complementary to their efforts to reduce trade barriers, that it was being addressed by the Treasury as part of a broader macroeconomic context and of course pointed out the provision in the trade bill concerning currency manipulation.

The point I want to make is that if we can't get the currency manipulation issue addressed in the macroeconomic context, which I think is initially the proper place to try to do it, I think there is going to be a growing pressure to address it in a trade context one way or the other.

And, first of all, I assume that this point is being made to the Koreans and to other countries with whom we may be facing the currency manipulation issue. What success are you having in pointing out the consequences or the potential consequences of not moving in the broader framework and that it will simply then feed back into sector economics as the Congress looks at this matter?

Mr. MULFORD. We have made that point all along, Mr. Chairman, and I think gradually it has begun to have some effect on the countries. We have made it with Korea and Taiwan, and we have made it recently with the Japanese on the yen/dollar talks.

But I think this raises an important distinction that I would like simply to touch on for you, and that is the distinction between financial market liberalization, which includes access by foreign firms to financial markets and internal financial market mechanisms that result in the liberalization and freeing up of markets, and foreign exchange rate manipulation on the other hand.

In the case of Korea, we believe that they have had a manipulative foreign exchange system as well as closed financial markets. The financial talks that we are about to begin are aimed at helping to open their financial markets and also to touch on and improve the currency manipulation situation.

I think it is fair to point out in Korea's case that they have begun to adjust their external imbalances quite sharply. There has been very substantial improvement reported, for example, in the first eight months of 1989. Korea's current account surplus fell by 66 percent to $2.8 billion and its trade surplus to $2.3 billion, which is a 63 percent decline, and through August the United States bilateral trade deficit with Korea fell 25 percent and was based on an increase in our exports to Korea of 22 percent.

So I think it is clear that adjustment is taking place, and we acknowledge this, but we still believe that the Korean foreign exchange system is inherently manipulative and the closely regulated financial markets that they operate, which in fact deny access in many areas to foreign institutions—access to local currency funding, for example, restrictions on establishment and branching for banks, access to check clearing and ATM networks, and so on—these are issues that we think need to be addressed quite apart from the currency issue in Korea, and the talks will focus on both of those areas.

Senator SARBANES. Well, let me address this current account surplus situation of theirs.

As I understand it, their current account surplus rose sharply in 1988, is that correct?

Mr. MULFORD. In 1988?

Senator SARBANES. Yes.

Mr. MULFORD. Yes, that is right. They had a very sharp rise.

Senator SARBANES. OK. Then in 1989, its current account surplus declined. Now, as I understand it, it is our perception that the reasons for this decline—that many of the reasons at least are perceived not be lasting reasons.

Mr. MULFORD. I would agree with that. We have the same concern that the decline is in part a reflection of temporary factors. We agree with that.

Senator SARBANES. Well, my concern is that a country will point to a decline in its current account surpluses and then sort of say, well, that has happened and therefore we shouldn't really focus or pay attention to currency manipulation.

I don't agree with that. I think the currency manipulation has to be straightened out. We have to reach a point where a judgment can be reached that a nation is not engaged in an effort to manipulate its currency in order to gain a trade advantage.

Now, the fact that its surpluses may have dwindled somewhat does not eliminate that problem that nevertheless remains from currency manipulation.

Mr. MULFORD. I completely agree with you, Mr. Chairman. We are very concerned and have said to the Koreans we are very concerned about the fact that they have depreciated their currency. Although it is only a modest depreciation, we think it is inappropriate for them to depreciate their currency, and we think they have made virtually no progress in attacking the fundamental exchange rate system they operate which, as I have said, we believe is manipulative.

In Taiwan they have made substantial progress in actually changing their foreign exchange system, so that it is not as manipulative a system as it was, and that represents real progress. In addition, they have made some progress on adjusting imbalances. So we feel in Taiwan the progress, relatively speaking, has been much more impressive.

In Korea, I agree with your assessment that the improvement in the surplus figures looks as if it may be based on temporary factors and the exchange rate problem looks unresolved at this point and needs further attention.

Senator SARBANES. Now, you say these talks are to begin in January?

Mr. MULFORD. We hope they begin in January, Mr. Chairman.

Senator SARBANES. Why the delay in getting them underway, or what I would perceive to be a delay? Perhaps it is not.

Mr. MULFORD. Well, the agreement in principle to have them was just reached. It was first discussed at the time of the IMF World Bank annual meetings in late September, and they came back and agreed in principle I think in late October. We have had in November a very heavy schedule of other talks to conduct and we felt it was best to schedule them for January. It is essentially a question of scheduling.

Senator SARBANES. I think it is important, again, to make sure that as you go into these talks that it is understood that there is a growing pressure in the Congress. If we can't get the currency manipulation issue addressed in the forum that has been designed for

it, which is your forum and these talks, there is a growing mood, I think, in the Congress to try to seek adjustment for the currency manipulation in various trade talks that are underway.

That, in effect, is the message of this letter that was sent by some of my colleagues to Carla Hills, that there be an effort as we address direct trade questions, in effect, which introduces an element of the currency manipulation and seeks adjustments of some sort on the trade side.

Now, I am not advocating that. I would rather have the currency manipulation eliminated in the framework in which you have been trying to approach it and, obviously, as you indicate, with some success in the case of Taiwan, but it must be made clear, I think, as you go into these talks beginning in January that this is a growing factor, at least in the thinking of the Congress.

Mr. MULFORD. Well, personally, Mr. Chairman, if the Congress does make clear its views in this regard, I have no problem with that because I think that and because I agree with you. It is far preferable to try to deal with these problems Ministry of Finance to Ministry of Finance because these really are financial and market questions, and it would be, I think, in a way a less productive method to turn to trade-type solutions.

But on the other hand, unless the countries cooperate, I think there is a risk that the Congress will force movement in that direction, and I hope the countries understand that.

Senator SARBANES. Well, I am in effect putting a charge on you to help to make them understand it as a very clear and strong message coming from the Congress on this issue. We have got to bring an end to this manipulation of currency. It is contrary to all rules for international trade.

The premise of the commitment to an expanding international trading system is that you are going to have rules that work equally and fairly for all parties involved, and for nations to participate in the system to manipulate it in order to gain an unfair advantage is not going to be tolerated.

Now, some of these countries are not the largest trading partners. They don't have necessarily the largest surpluses, but nevertheless it mounts up and there is now a focus to get these rules to work in a fair way, and I think it is important to try to straighten this issue out at the same time that the extended GATT discussions are now taking place, which hopefully will lead to reducing trade barriers and another impetus to expanding international trade.

I would like to ask next about the G–7 finance ministers' statement, and I guess that was in September.

Mr. MULFORD. Yes.

Senator SARBANES. Where they agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy.

So I take it the ranges that that statement was meant to encompass was no rise, perhaps some decline, but not excessive decline; would that be correct?

Mr. MULFORD. That is correct.

Senator SARBANES. Now, do you think we should have had a statement of that sort at the Paris summit?

Mr. MULFORD. I think that the problem with the summit forum is that it is not a forum where the G–7 meets. The G–7 Financial Ministers do not meet in the same format that they would for a G–7 Ministerial, because the Central Bank Governors or Chairmen of central banks do not attend the summit and therefore cannot meet in the normal format with the G–7 ministers. With regard to making statements type about foreign exchange markets, it is very difficult to do so without having both the Finance Ministers and Central Bank Governors present at the same gathering.

I think it is very important that when a consensus statement is made of the type that was made on September 23rd that world markets understand that it is Finance Ministers and Central Bank Governors speaking with one voice in the communique, and that is a very important part of the process.

Senator SARBANES. Well, now subsequent to this G–7 statement, as I understand it, the central banks did sell dollars significantly, is that correct?

Mr. MULFORD. That is correct. There was coordinated intervention following the meeting.

Senator SARBANES. And Germany and Japan also raised their interest rates?

Mr. MULFORD. That is correct, and the United States subsequently has reduced its short-term rates, although it has not changed its discount rate. But there has been some easing of Fed funds rate in the United States on two occasions since the meeting.

Senator SARBANES. But it is not comparable—would you regard what the Fed has done here on lowering interest rates, to the limited degree you have indicated, as comparable to what Germany and Japan did in raising interest rates?

Mr. MULFORD. That is a very hard judgment to make because I think that what the Fed does in a sense carries more weight in the exchange markets with reference to the position of the dollar than the actions taken by Germany and Japan have on dollar exchange rates.

So what I am saying is that in a way the Fed doesn't have to do as much to make a significant impact, and if foreign central banks raise their rates, that may or may not have a substantial effect on dollar exchange rates. It is not quite as clear as the Fed linkage is.

Senator SARBANES. When did the Fed take its action?

Mr. MULFORD. I believe its first action was around October 13th. I think it began around October 11th, on Wednesday, Thursday, with a decline in the Fed funds rate, which then was more visible on October 13th.

Senator SARBANES. When did Germany and Japan take their action?

Mr. MULFORD. From memory, Mr. Chairman, I believe they both took their action somewhat before that; in other words, in the early days of October.

Senator SARBANES. Accepting for the moment your point on the difference in magnitudes, not differing with you on the position that the Fed in magnitude can do less but its import may be equal or greater as to the raising, let's address the issue of timing.

There is some concern that by not acting in the same immediate time frame as West Germany and Japan that the Fed to some

extent undercut what might otherwise have happened with respect to lowering the value of the dollar. Most people, I think, thought that there was a modest decline and that if the Fed had acted in a more timely fashion, even at the same magnitude, that we would have had more of an impact on the dollar decline, that you got mixed signals at that time and therefore the impact was weakened, diminished.

Mr. MULFORD. Well, Mr. Chairman, I don't think I would agree with that interpretation because I think that we have to bear in mind that the Federal Reserve—and I think they really should speak for themselves here—faces a wide variety of considerations in making its decisions, and I don't want to comment on that full range of policy considerations.

I would simply say that I think that what took place in the exchange markets after the meeting was accomplished effectively by the consensus statement in the communique and by coordinated action in exchange markets by the major central banks so that the markets understood what was happening. I don't think the Federal Reserve's posture or timing was negative in that regard.

Senator SARBANES. Well, now on the 9th of October the Wall Street Journal ran a story, headlined "Fed Resists Cutting Rates To Lower Dollar," and then the subheading to it is "Decision To Defy Treasury's Plea Escalates Tension Within the Administration."

Let me just read a couple of sentences from it.

> The Federal Reserve is resisting domestic and international pressure to reduce interest rates to bring down the dollar, causing escalating tension between it and the Bush Administration. Treasury officials for weeks have been urging the Fed to ease rates to stem the dollar's rise in international exchange markets, but Fed officials are defying Treasury's pleas, arguing that the central banks' policy should be geared toward fighting inflation rather than bringing down the dollar. In a surprise move two top Fed officials even voted late last month to oppose the Treasury's efforts to sell dollars to drive down the currency in international exchange markets.

Mr. MULFORD. Well, that makes for very good copy, Mr. Chairman.

Senator SARBANES. It does, and it obviously makes for a question at a hearing. I would be interested in the response.

Mr. MULFORD. Let me just respond as follows to that, without commenting particularly on that article, because I think it is in a way a generic issue. There has been a lot of speculation in the press about differences between the Treasury and the Fed, as this article indeed refers to.

My feeling on that is that there are not important differences and there were not important differences at that time between the Treasury and the Fed. The policy statement made by the G–7 ministers was a unanimous statement. Secretary Brady and Chairman Greenspan were both at the meeting and were in full agreement with the statement, and there was close cooperation after the meeting between the Treasury and the Federal Reserve in markets, as there was with other central banks. Therefore, I believe that for some reason, which I am not entirely clear on, there seems to be a lot of unwarranted speculation about tensions in the relationship.

Now, I think it is fair to say that on policy issues there are what I would call different nuances between the Treasury and the Fed,

as indeed there should be. They are, I would say, in a sense institutional differences by virtue of the two institutions and their relative roles in our economy, so that there are nuances in terms of policy views. But these have not been significant in recent times, and in terms of my own experience in recent months I think they have been much less than they have been at other times.

So I simply don't think there is any credence really to the theme that is put out in that article of substantial tension between the Treasury and the Fed in this area.

Senator SARBANES. What did you think of this vote by some members of the Fed to oppose Treasury's efforts to sell dollars to drive down the currency in international exchange markets?

Mr. MULFORD. Well, Mr. Chairman, I think you should address that question to the Fed.

Senator SARBANES. Well, we certainly intend to.

Mr. MULFORD. But my impression of that vote is that it had to do with a technical issue where arrangements are made to provide additional resources for the purposes of intervention and that the issues involved in the vote were not, strictly speaking, just exchange rate issues. There were also other issues in play within the Fed that had an effect on that vote.

That is just my understanding.

Senator SARBANES. This was on October 9th. Now, you know, in the earlier testimony Japan and Germany took their interest rates up earlier than that and the Fed, to the extent that it took the interest rates down, did so subsequent to that, to this article and this apparent asserted rift—do you think that the dollar decline would have been greater had the Fed lowered the interest rates at or roughly about the same time as Germany and Japan took their interest rates up instead of appearing to be working at cross purposes?

Mr. MULFORD. I honestly, Mr. Chairman, don't believe that would have had much of an effect because you never know. It is impossible to answer the question.

Senator SARBANES. But you did have a mixed signal for a while, did you not?

Mr. MULFORD. You could take that position if you were of a mind to do so. But I think that the significant event, in my opinion, was the consensus view of the G–7, which sent a very strong message to the markets. The wording that you read was understood to be a very clear judgment by Ministers and Governors and a very clear signal, and the purpose of that language was to send a signal to markets which in effect said you should reassess the fundamentals because the judgment here is that the recent strengthening of the dollar is not really in line with long-term fundamentals.

The market did respond by making a reassessment, and there was, as I said, coordinated activity in markets which the market sees as evidence of close cooperation backing up the consensus statement.

Then I think one has to recognize that in a way events become a little blurred by virtue of the stock market break on October 13, which also contributed to a reassessment in the market of economic fundamentals, and this again has played a continuing role.

All I can say is that since the meeting, the combination of the statement, the interest rate decisions that were made in Japan and Germany and the easing that has taken place in the United States, and other market developments have resulted in a situation where the dollar now stands and has stood for almost 2 months at something like 8 percent below the peak against the deutsche mark in mid-September and about 4 percent below the peak against the yen in mid-September, and I judge that to be a reasonably significant accomplishment.

Senator SARBANES. Now, the Federal Reserve's Chairman Greenspan frequently states that reducing the domestic rate of inflation to near zero is his principal objective. Now, of course that suggests a continued tightness in monetary policy. Such a tightness of course would tend to make the dollar more attractive to international investors, thereby push up its value and have an impact on our exporters and on the trade balance.

What is your view as to whether an emphasis on monetary policy aimed at a domestic price stability at the level of zero inflation or near zero, near zero, the effect of that on a continued strong dollar and therefore a continued high trade deficit?

Mr. MULFORD. Well, I think it is very important, Mr. Chairman, to have three objectives very much in mind in international economic policy formation.

One is to work to ensure the continuation of solid growth. That I think is a very high priority.

Second, it is very, very important to maintain a continuing vigilance against inflation, and to me that means that you not only guard against rising inflation, but you seek to further reduce inflation.

And, third, and in my view very, very important, we must continue to adjust our external imbalances.

Those are three objectives that have to be fitted together in policy terms in a way that allows you to pursue all those objectives effectively, and there is a question of balance among the various objectives that has to be achieved.

So I wouldn't get so specific as to say at what level you have to get inflation to over what period of time or exactly what level of trade deficit you have to have worked down to by a particular period. What is important is to continue making progress in these areas and to maintain continuing growth.

Senator SARBANES. Well, on this point of adjusting the external imbalances, I agree very strongly with it. I think I am struck by your report on pages 14 through 16, by the relative equanimity in which you view the question of the sustainability of this U.S. current account position and these—it seems to me, particularly, now reflecting a deficit on our investment account. As I understand it, the figures reported by the Commerce Department in the last quarter for the first time showed a deficit on the investment side, is that correct?

Mr. MULFORD. Yes.

Senator SARBANES. How can you be so relatively calm about this emerging situation? Isn't it more of a serious problem than is suggested in this report?

Mr. MULFORD. I think, Mr. Chairman, the report attempts to convey the progress that has been accomplished, in part through successful economic policy coordination, in reducing our external imbalances. The improvement in the trade deficit we have seen in 1988 and in 1989 is a solid accomplishment, I think, but with diminishing strength in 1989. In other words, the momentum of adjustment has clearly slowed in 1989.

And what I think the report tries to point out is that unless there is further progress on the policy front this adjustment process could lose momentum. Unfortunately, if the trade deficit levels off at, let's say for argument's sake, around $100 billion or so, in our situation, because of our heavy indebtedness, the effect will be to see a deterioration in our current account.

Senator SARBANES. That is right. That is why I think it is so serious.

Mr. MULFORD. And I agree with you, Mr. Chairman, that that is a very important and a negative development. So obviously we feel that we have to make further progress on the adjustment of external imbalances.

Now, you have raised a question here of how sustainable is this situation, and I think the answer to that is extremely difficult to give because markets clearly operate on the basis of positive trends. If you get a clear reversal of the trend, the markets will probably feel less positive about that and obviously it creates important constraints in terms of policies if those negative things begin to develop.

Senator SARBANES. Well, let me underscore why I think this report is treating this problem a little cavalierly. In the conclusions on page 27, at the end of the second paragraph, there is a sentence that reads as follows:

> External imbalances, which in the mid-1980's were projected to grow to unsustainable dimensions on the basis of then prevailing policies and prospects, have been substantially reduced.

And I had a comment that was as follows. They have not been reduced. Only their growth rate has been reduced.

Mr. MULFORD. Well, I think there's two issues there. One is that if you go back to the time of the Plaza, when the judgment was made that it was necessary to begin more strongly an adjustment process, we were seeing clearly the growth of a trade deficit figure and potential current account deficit that would be very substantial if it continued to grow at those sort of levels.

The actions that have been taken in the meantime have in fact done two things. One, they have changed the sort of projection of that trendline from that to this, and they have actually made progress in reducing our external imbalances.

So there is in my view very substantial progress because——

Senator SARBANES. When you say external imbalances, you are talking about the current account deficit?

Mr. MULFORD. I am talking about the trade account deficit and the current account deficit.

Senator SARBANES. But they are still significantly in the negative?

Mr. MULFORD. Yes.

Senator SARBANES. So they continue, therefore, to enlarge the extent to which the United States is a debtor country?

Mr. MULFORD. The continued large trade deficit does continue to contribute to further indebtedness of the United States, that is correct.

Senator SARBANES. So even if you reduce the trade deficits from, say, $150 to $100 billion, to use the figure you had, which is no insignificant improvement—I mean I recognize that—but nevertheless at the end of that year we are still $100 billion more in the hole than we were at the beginning of the year; is that not correct?

Mr. MULFORD. That is correct.

Senator SARBANES. And this deficit on the investment account will therefore worsen and be an even larger offset to any improvement that you achieve in the trade area?

Mr. MULFORD. That is correct, and I would like to reiterate, Mr. Chairman, that is one of my primary concerns and I place this at a high priority position with our G-7 partners and impress upon them the necessity to continue adjusting external imbalances, not only with them but with Korea and Taiwan and with the debtor nations, and so on, because the United States must continue to make progress in reducing these imbalances. Of course, an important ingredient here at home of that process is the necessity to reduce our federal fiscal deficit. This could be a very positive contributor to further reduction of imbalances.

Senator SARBANES. I have one other question. Senator Heinz is here, and then I will defer to him.

I take it you are surveying all of the countries in the course of making these reports, is that correct?

Mr. MULFORD. That is right, yes.

Senator SARBANES. And is it the Treasury's perception that only in Taiwan and Korea have we faced a currency manipulation?

Mr. MULFORD. I think the answer to that is that only in Taiwan and Korea among the important trading nations have we made that judgment, and that judgment is a very important judgment to make. I think it is perfectly possible in other countries which would be categorized as developing countries to pick out exchange rate practices that are manipulative for some advantage or other. The tendency, however, has been to focus on those countries that are major players in the trading area.

So I am saying it is possible if you made a further study that you could find other cases that you could compare to Taiwan and Korea, but they would be in the overall scheme of things much less important.

Senator SARBANES. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, thank you very much.

I apologize for not being here at the outset, but I had two other hearings this morning. This happens to everybody, including the Chairman.

I commend the Chairman for his attention to this subject and to the testimony we are receiving this morning.

I want to raise an issue if it hasn't—and I apologize if it has been raised before, David. It is an issue that we raised with you last in May, and it is the subject of Korea.

In your report basically you do not report much progress on your negotiations with Korea, and obviously the Treasury first cited the Korean Government for artificial manipulation of its currency and consequent failure to allow the won to appreciate against the dollar a year ago. You did so again last April, and based on your current report, it is difficult to see any progress at all.

Now, I note that the won actually depreciated against the dollar during the last 6 months, which is in sharp contrast to the new Taiwan dollar, which has gone up some 60 percent more than the won against the United States dollar since 1985, and it is a problem that concerns me. I run into it repeatedly, for example, in the steel sector, as I said at the last hearing, where the Koreans regularly describe themselves as fair traders. We were just in negotiations with them on steel VRA's, and they say, well, we are not doing anything wrong, we are trading fairly, and that ignores completely the fact that currency manipulation is in fact a subsidy.

That is what it amounts to if a government is manipulating its currency, and you, yourself, acknowledged that at the last hearing.

It is also—currency manipulation—a very effective means of avoiding liability in dumping cases, and the Koreans in my judgment have proved it to be an effective means, therefore, of gaining an unfair competitive advantage in international trade. They have found a way to get around the dumping code; namely, through currency manipulation, and the result is it is American workers and American companies and American communities that are suffering.

And so my question to you is, since we recognized the problem a year ago, since you came here before the committee and basically made a speech not dissimilar to the one I have just made this moment, why have we made so little progress this past year and what are our plans for the future to try and achieve more progress?

Mr. MULFORD. Well, I think your summary is very accurate. I agree with it.

But I think we need to have a sense of perspective on what has been accomplished. Since our first currency negotiations with Korea began in 1986, the won has appreciated by about 30 percent. That is less than Taiwan and less than Japan, and so on, but it is not a insignificant number. It has appreciated by about 6 percent since our first report to Congress in October of 1988; in other words, about a year ago.

But during 1989, and in particular since, I guess, since about April 1989, Korea has actually depreciated slightly its currency, as you pointed out.

We have taken a very dim view of that, and we have told the Koreans that we don't agree with that approach, and, moreover, they have coupled that with a number of comments about restoring export incentives, and so on, and we have also let them know that we don't appreciate that sort of approach either.

We have continued to say to the Koreans two things, that we want to see them ready to appreciate their currency further if

their surplus situation justifies it—and we believe in due course that will be necessary—and we have said to them that they have not looked to and made improvements in their currency system. It is still a manipulative system; whereas, Taiwan has made substantial changes in its underlying system.

When we begin these financial market talks in January that have already been discussed here, they will focus on financial market liberalization, access by foreign firms to the financial market, and so on. But they will also concentrate on the currency issue and we will further discuss this issue with them and impress upon them the importance of making further progress.

They have made substantial adjustment, and just to give you those figures, in the first eight months of 1989 Korea's current account surplus fell 66 percent and its trade surplus fell 63 percent. Our bilateral deficit fell 25 percent with Korea to $4.2 billion, and we experienced a 22 percent growth of our exports to Korea against a 3 percent growth in our imports from Korea.

So there is there a very substantial change. The question is whether that is really going to be sustained or not.

And, finally, in general one has to remember that although the Koreans have not appreciated their currency much lately, because the dollar has itself appreciated against other currencies, Korea's overall position against the rest of the world has been detericrating. In other words, it is losing its trade advantage against the world in general.

Senator HEINZ. To put the numbers in a more historical context, you mentioned that the won had appreciated some 30 percent since the beginning of 1986?

Mr. MULFORD. Yes.

Senator HEINZ. What was the appreciation of the Taiwanese currency in that period of time?

Mr. MULFORD. Well, if you go back to the time of the Plaza, for example, the won has appreciated by 33 percent, the new Taiwan dollar has appreciated by 57.5 percent, and the yen has appreciated by 70.5 percent, and I suppose the DM must be around 54 percent. That puts it into perspective.

Senator HEINZ. All right.

Now, you mentioned that the Koreans are still manipulating their currency. What are the principal manipulative practices that we would like to see them stop?

Mr. MULFORD. Well, basically they just tightly control the supply of the currency to the system so that a free market based on supply and demand reflecting the fundamentals of their economic situation cannot operate.

Senator HEINZ. And give us an example of a couple of those practices that are elements of that control.

Mr. MULFORD. Well, for example, foreign banks effectively can't even really participate in the foreign exchange market. They can exchange currency at what is designated effectively at the official rate, but they can't make markets.

It is so tightly controlled that in effect there isn't a real market operating.

Senator HEINZ. Any other practices?

Mr. MULFORD. In a way, this is tied up with access problems of a more general type for banks. For example, U.S. banks in Korea do not have access to local currency funding and therefore because they don't have that access can't effectively participate in the exchange market.

There are restrictions on establishment and on branching. There are restrictions on access to check clearing and ATM networks and on the ability to collateralize loans effectively.

So when you take all those sorts of things together, banks cannot effectively operate in the exchange market, and in a sense all the government does is set what it believes to be the right rate and they maintain that rate by controlling the entire situation.

Senator HEINZ. And their banks do not attempt to make markets; they follow the government's—are they required by law to follow the government?

Mr. MULFORD. I am not sure they are required by law, but they certainly would not take a chance in defying the government on the foreign exchange rate, nor would a foreign bank, in effect, attempt to intervene in markets and draw the disapproval of the government.

Senator HEINZ. Very well.

Mr. Chairman, I have no further questions.

Senator SARBANES. I just have a couple more, Mr. Secretary.

One is on the economic policy coordination issue. I take it is the G–7 that you essentially see as the forum for the coordination of policy; would that be correct?

Mr. MULFORD. That has been the forum for the development of the economic policy coordination process, but it is not a process that is really restricted to the G–7. There are policy coordination discussions that go on at G–10 meetings and at OECD meetings, and you could even say that when we have bilateral meetings with the Japanese or the Germans we indulge in a certain amount of policy coordination.

So it is not exclusive to the G–7, but that is where the really effective global macroeconomic policy coordination process has developed and been cited.

Senator SARBANES. I am somewhat concerned by what I see as a diminishing role for the OECD, recognizing that it is easier to just have seven parties and talk, and you can argue that these are the largest economies.

Nevertheless—and it will take a lot more effort—wouldn't there be something to be gained by broadening the number of participants in the coordination or have we reached a point where if you did that you would have to broaden it so far that you wouldn't be able to achieve coordination?

Mr. MULFORD. I would like to say at the OECD, for example, the meeting of the so-called Working Party 3, which is an economic policy coordination group, which I personally attend as often as I can, is a very effective forum for really in-depth policy discussions, much more in-depth in many ways than those that take place at ministerial level in what is sometimes a rather short meeting in the G–7.

But the problem with that type of forum or with the IMF Interim Committee, for example, which is another place where there is

an exchange of views, the problem is that those are not action-oriented groups, partly because of the level of representation, but also because of the numbers and diversity of the representation.

The G–7, on the other hand, is a body which is able to, particularly because it meets in confidence and also very informally without a secretariat or any report being released, et cetera, is able really to take action that is significant in terms of measures. I think that it is very important to spread as widely as possible the policy coordination dialogues and discussions because I think those help lay a basis for progress, but it has generally been in the G–7 context that the action-oriented approach has emerged.

Senator SARBANES. Are Korea and Taiwan members of the OECD?

Mr. MULFORD. They are not, no.

Senator SARBANES. Would a purpose be served if they were to be members?

Mr. MULFORD. Well, I think they would both have to make application to join. Neither of them have yet done that. I think in due course if they were to make such application it is probably something that would be considered.

Senator SARBANES. Do you think they are now sufficiently significant players on the international economic scene in terms of their economic role that they should be more involved in some of these international groupings that are concerned with matters of economic policy coordination?

Mr. MULFORD. Yes, I do, Mr. Chairman. I agree with that.

The problem is that it is difficult to know how to incorporate them because there are a number of other problems, not, strictly speaking, economic, that have to be addressed in that process because of the status of some of the newly industrialized economies.

Hong Kong is another one, which is an unusual status, and therefore the business of bringing them into groups tends to be very complex diplomatically.

Senator SARBANES. Well, Hong Kong after 1997 will in effect be encompassed within—although they have been assured of a separate system, they will still be encompassed within the PRC, will they not?

Mr. MULFORD. That is correct.

Senator SARBANES. How long do you think these talks will take that are going to open with the Koreans in January to produce some observable results?

Mr. MULFORD. If I were to go back to the yen/dollar talks, Mr. Chairman, which began in earnest in January 1984, we produced our first report, I believe, in June of 1984. We made some substantial progress in those early months and then we have continued the meetings with the Japanese and there has been steady progress ever since—although not enough, I might emphasize.

It seems to me in Korea we should aim within a period of six months to have made some kind of definitive progress that is visible and can be demonstrated.

Senator SARBANES. Well, let me give you a little tighter schedule than that.

You are to come back, I think, with an update of this report in April of next year.

Mr. MULFORD. Yes.

Senator SARBANES. Is that correct?

Mr. MULFORD. That is correct.

Senator SARBANES. Well, I want to put it in very simple terms.

The Congress is about to adjourn if everything goes according to plan in the next week, we hope, to come back in late January to resume the next session of the 101st Congress.

So beginning at the end of January of next year, we will be back in session then for that Congress. You are opening your talks in January. You are to update your report on April 15th.

I had not had a prior discussion with Senator Heinz before he arrived this morning, but I was interested to see that his questioning to you covered in fact an area that we had touched upon and which obviously again reflects the concern here in the Congress on some of these issues, and so I would expect that your next appearance before us on updating this report is—obviously a good part of that hearing is going to focus on this currency manipulation inquiry and the progress of those talks.

Now, of course the Congress will also be looking at trade measures in the course of next year. So we need to move.

There is no more tolerance here on the Hill for using direct manipulation to gain an advantage in trade, and it has got to come to an end.

That doesn't mean that these problems will automatically be resolved. They have lots of other factors also involved, but at a minimum we ought to get out of the picture a failure to play strictly according to the rules, and I think that is the admonition with which I would close this hearing.

I mean, that is in effect giving you a charge as you go into those discussions that you are about to open in January.

Mr. MULFORD. Well, Mr. Chairman, I am happy to make every effort to work to a timetable that would begin early next year and aim at producing some result that we can report to you on by April.

Senator SARBANES. You know, this is a new procedure. We think it is producing results, and we have tried to work in consultation with the Treasury, but at some point if we don't get results the frustration and the impatience on the Hill is going to mount and you may see the Congress moving off in other directions in order to try to achieve some remedies.

Mr. MULFORD. I understand.

Senator SARBANES. Well, thank you very much, Mr. Secretary.

Mr. MULFORD. Thank you very much, Mr. Chairman.

Senator SARBANES. We appreciate your testimony and the report.

Mr. MULFORD. Thank you.

Senator SARBANES. The committee will now hear from the Vice Chairman of the Board of Governors of the Federal Reserve System, the Honorable Manuel Johnson.

Mr. Johnson, we are pleased to have you before us, and we would be happy to receive your testimony now.

STATEMENT OF MANUEL H. JOHNSON, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. JOHNSON. Thank you, Mr. Chairman.

I do appreciate the opportunity to appear before this subcommittee to comment on the Treasury Department's report on U.S. international economic and exchange rate policy.

As indicated in the report, there has been considerable change in the U.S. trade and current account balances over the past couple of years. The current account deficit, which peaked at $160 billion in 1987, had declined to $106 billion at a seasonally adjusted annual rate by the first half of this year. As a percentage of GNP, the decline has been from 3½ percent to 2.1 percent over this same period.

The decline in our merchandise trade deficit has been of about the same magnitude. The volume of U.S. exports has been increasing at an average annual rate of about 20 percent for nearly 3 years now, while the rate of growth of the volume of our non-oil imports has slowed substantially.

The counterpart to the reduction in U.S. external deficits of course is the reduction in external surpluses in a number of countries abroad, notably, Japan, Taiwan, and Korea; also, a massive movement into current account deficit in the United Kingdom; and some further increase in deficits of some of the European countries.

Japan's surplus declined from $87 billion in 1987 to $67 billion at a seasonally adjusted annual rate in the first half of 1989. Taiwan's current account surplus declined from $18 billion in 1987 to a $10 billion rate in the first half of this year. Korea's surplus likewise declined from $14 billion in 1988 to about $4 billion at an annual rate this year. In the United Kingdom, current account deficit moved from $5 billion in 1987 to a deficit rate of $32 billion in 1989's first half.

On the other hand, there was no reduction in Germany's surplus, which actually rose from $46 billion in 1987 to a $59 billion annual rate in the first half of this year, accounted for by an increase in Germany's surpluses with its EC partners.

The dramatic change in U.S. external balances in the past 2 years was the result of the earlier decline in the dollar against major foreign currencies, and against the Taiwan dollar and the Korean won, also, increases in productivity and cost competitiveness by U.S. producers, the slowing of the rate of growth in U.S. domestic demand, and a sharp increase in the rate of growth of domestic demand overseas.

While the adjustment process has continued, there are signs suggesting it has begun to slow. This reflects, in part, the necessary actions taken by foreign industrial countries to reduce the growth of domestic demand in order to contain inflationary pressures, and the continued relative attractiveness of assets denominated in U.S. dollars which has bid up dollar exchange rates.

Now, since our current account deficits are significantly lower than they were in 1985 through 1987, the sustained financing of such deficits is more likely now than was the case earlier. And in thinking about options to improve our external accounts further, it must be remembered that a significant portion of our current ac-

count deficit reflects a worldwide saving-investment imbalance. Accordingly, any strategy designed to reduce the trade deficit should focus on policies that address this fundamental structural issue. Removing the many distortions which adversely affect U.S. savings must be high on the policy agenda.

Recent suggestions by Treasury Secretary Brady to increase U.S. private savings I think are constructive. Reducing government deficit spending must also be a high priority in order to free up more overall domestic savings and help lower relative real interest rates.

In present circumstances, with the U.S. economy close to capacity constraints, and monetary policy focusing on containing inflationary pressures, there is less room for substantial further reduction in U.S. external deficits, absent a significant reduction of the saving-investment imbalance.

In the meantime, our efforts should concentrate on maintaining and improving the environment for the free flow of capital and on resisting protectionist non-solutions.

The recognition that balanced and mutually consistent economic policies among major countries are essential for a healthy and stable world economy underlies the dialogue not just with other G-7 countries, but also with the newly industrializing countries as well.

We are pleased to see that considerable progress has been made in Taiwan and Korea over the past year in terms of allowing market forces to be reflected in the operation of their exchange markets.

Having said all of this with regard to external adjustment, it is important to emphasize that the G–7 process of international economic policy coordination properly is not concerned primarily with exchange rates or external adjustment, per se. Rather, the aim is to achieve and to sustain the maximum long-run growth for the world economy consistent with low inflation.

Current account imbalances and exchange rates become matters of policy concern when they threaten to lead to financial market and other disturbances which could thwart the attainment of the fundamental goal of sustainable growth with low inflation.

Thank you, Mr. Chairman.

[The complete statement of Manuel H. Johnson follows:]

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Testimony by

Manuel H. Johnson

Vice Chairman

Board of Governors of the Federal Reserve System

before the

International Finance and Monetary Policy Subcommittee

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate

November 16, 1989

I appreciate the opportunity to appear before this Subcommittee to comment on the Treasury Department's report on U.S. international economic and exchange rate policy.

As indicated in the report, there has been considerable change in the U.S. trade and current account balances over the past couple of years. The current account deficit (excluding capital gains or losses reported by direct investors), which peaked at $160 billion in 1987, had declined to $106 billion at a seasonally adjusted annual rate by the first half of this year. As a percentage of GNP the decline has been from 3-1/2 percent to 2.1 percent over this same period.

The decline in our merchandise trade deficit has been of about the same magnitude. The volume of U.S. exports has been increasing at an average annual rate of about 20 percent for nearly three years, while the rate of growth of the volume of our non-oil imports has slowed substantially.

The counterpart to the reduction in U.S. external deficits is the reduction in external surpluses in a number of countries abroad, notably Japan, Taiwan, and Korea; a massive movement into current account deficit in the United Kingdom; and some further increase in deficits of some other European countries. Japan's surplus declined from $87 billion (3.6 percent of GNP) in 1987 to $67 billion (2.3 percent of GNP) at a seasonally adjusted annual rate in the first half of 1989. Taiwan's current account surplus declined from $18 billion in 1987 to a $10 billion rate in the first half of this year. Korea's surplus likewise declined from $14 billion in 1988 to about a $4 billion annual rate this year. And the U.K. current account deficit moved from $ 5 billion in

1987 to a deficit rate of $32 billion (3.8 percent of GNP) in 1989's first half.

On the other hand, there was no reduction in Germany's surplus, which actually rose from $46 billion in 1987 to a $59 billion annual rate (5 percent of GNP) in the first half of this year, accounted for by an increase in Germany's surpluses with its EC partners.

The dramatic change in U.S. external balances in the past two years was the result of the earlier decline in the dollar against major foreign currencies and against the Taiwan dollar and the Korean won, increases in productivity and cost competitiveness by U.S. producers, the slowing of the rate of growth in U.S. domestic demand, and a sharp increase in the rate of growth of domestic demand abroad. While the adjustment process has continued, there are signs suggesting it has begun to slow. This reflects, in part, the necessary actions taken by foreign industrial countries to reduce the growth of domestic demand in order to contain inflationary pressures, and the continued relative attractiveness of assets denominated in U.S. dollars which has bid up dollar exchange rates.

Since our current account deficits are significantly lower than they were in 1985-1987, the sustained financing of such deficits is more likely now than was the case earlier. In thinking about options to improve our external accounts further, it must be remembered that a significant portion of our current account deficit reflects a worldwide saving-investment imbalance. Accordingly, any strategy designed to reduce the trade deficit should focus on policies that address this fundamental structural issue. Removing the many distortions which adversely affect U.S. savings must be high on the policy agenda. Recent

suggestions by Treasury Secretary Brady to increase U.S. private savings are constructive. Reducing government deficit spending must also be a high priority in order to free up more overall domestic savings and help lower relative real interest rates.

In present circumstances, with the U.S. economy pressing on capacity constraints and monetary policy focussing on containing inflationary pressures, there is little room for substantial further reduction in U.S. external deficits absent a significant reduction of the saving-investment imbalance. In the meantime our efforts should concentrate on maintaining and improving the environment for the free flow of capital and on resisting protectionist non-solutions.

The recognition that balanced and mutually consistent economic policies among major countries are essential for a healthy and stable world economy underlies the dialogue not just with other G-7 countries but also with the newly industrializing countries. We are pleased to see that considerable progress has been made in Taiwan and Korea over the past year in terms of allowing market forces to be reflected in the operation of their exchange markets.

Having said all this with regard to external adjustment, it is important to emphasize that the G-7 process of international economic policy coordination properly is not concerned primarily with exchange rates or external adjustment per se. Rather, the aim is to achieve and to sustain the maximum long-run growth for the world economy consistent with low inflation. Current account imbalances and exchange rates become matters of policy concern when they threaten to lead to financial market and other disturbances which could thwart the attainment of the fundamental goal of sustainable growth with low inflation.

Senator SARBANES. I would like just to get a couple of clarifications with respect to your report.

Mr. JOHNSON. Yes, sir.

Senator SARBANES. First of all, you say on page 3 that you are pleased to see that considerable progress has been made in Taiwan and Korea over the past year in terms of allowing market forces to be reflected in the operation of their exchange markets.

Mr. JOHNSON. Yes.

Senator SARBANES. But of course the Treasury report and the discussion we had before you came to the witness table made a rather sharp distinction between what has taken place in Taiwan and what has taken place in Korea.

In fact, the Treasury says—and this is talking about Korea:

> On balance, exchange rate developments over the past 6 months, in the absence of a role for market forces and exchange rate determination, are indications that exchange rate manipulation continued in the 6 months since the April report.

Now, on Taiwan, they say:

> At this time, there are no clear indications that Taiwan is manipulating its currency for competitive advantage.

And they previously pointed out that they were encouraged by the significant steps Taiwan has taken to liberalize its foreign exchange system, and allow its currency to more accurately reflect market forces. And then they go on to say that they need to continue to monitor the situation closely.

So they make what I would consider to be a rather significant distinction between the two countries. You lump them together in this sentence that I just read, and I would like you to elaborate on your perception.

Mr. JOHNSON. Yes, Mr. Chairman. Well, it is true, you can make a distinction between the two, in terms of their progress. But I think what I was trying to refer to was the fact that——

Senator SARBANES. And let me throw into that pot, for you to respond to, the facts that the Korean won has depreciated against the dollar this year, slightly, that the new Taiwan dollar has strengthened since the Plaza Agreement of September 1985. The new Taiwan dollar has strengthened by 57½ percent, the Japanese yen by 70 percent, the German mark by 54 percent, and the Korea won by only 33 percent.

Mr. JOHNSON. Yes. I think it is true. Those are the relative movements since the Plaza Accord. But it is hard to tell, if Korea had a perfectly free exchange rate mechanism, exactly where their currency would have settled. The same is true of Taiwan.

What I was trying to point out was that Korea has announced in September, through their finance ministry, their intention to go to full convertibilty and open exchange markets by 1992, and of course they plan to enter into negotiations soon and complete those talks by January 1990.

In the meantime, they have been willing to make adjustments in their exchange rate, although it is structured in a way where the system is controlled through official policy.

Nevertheless, I think that they are making progress, and they certainly appear to be sensitive to the concerns in the rest of the world about official pegging of the exchange rate. I think that they

are showing responsiveness, and have announced, as I said, in September their intention to go to full convertibility by 1992. So I think that that is progress, and certainly it shows signs of things moving in the right direction.

Taiwan has already moved to more smooth convertibility and open markets in their exchange rate. And so you can distinguish between the two systems in that sense; that Taiwan has made more progress in terms of fully integrating its currency, whereas Korea has simply started the process, and is moving in the right direction.

Senator SARBANES. Perhaps it should have said "considerable progress in Taiwan," and perhaps "some progress in Korea." Would that have been more accurate?

Mr. JOHNSON. Well, that might be more precise.

Senator SARBANES. Well, it is important. Because if we are going to follow the provisions of the trade bill, and require the Treasury to indicate where there is manipulation taking place, we have to make these distinctions; otherwise, it is not going to be fair to the countries involved upon whom those judgments are being passed.

Let me ask you, on the top of page 3, where you speak for increasing private savings, what is your view of increasing private savings at the cost of increasing public dissaving; namely, increasing the Federal deficit?

Mr. JOHNSON. Well, obviously, if you increase public dissaving, dollar-for-dollar, with an increase in private saving, you have not netted very much. The fact is that——

Senator SARBANES. Usually, it is even worse than that; isn't it? Usually, you try to provide some incentive for increasing private savings through, say, a change in the taxing system or something, which costs you public dollars, and you do not even get one-for-one, you get less than one-for-one. You lose the public dollar, and you do not get a full dollar of private savings out of it.

Mr. JOHNSON. Well, I think that first of all, you would have to look at that on a case-by-case basis. I think most of the research I have seen would indicate that attempts to provide savings incentive through tax rate reduction do contribute at the margin to savings, but of course you do lose revenue.

The question is whether the additional savings and capital formation that would result from that additional saving in the private sector partially offsets some of the revenue loss on the public sector side, so that it is not a dollar-for-dollar trade-off. So I think it is an empirical question. It is very hard to measure those things.

But the fact of the matter is that the easiest way to ensure that both private saving increase and public dissaving are reduced is to trim government spending.

Senator SARBANES. But some of the proposals for increasing private savings are to trim Government revenues. Isn't that correct?

Mr. JOHNSON. That is true.

Senator SARBANES. And I take it, you are not advocating those measures, I take it.

Mr. JOHNSON. Well, I have been a long advocate of a tax system that encourages saving and avoids the tax biases against saving. And so I have been a long advocate of consumed income tax.

But in fact, I think that it should be done as revenue-neutral as possible——

Senator SARBANES. Well, you seek to do it by discouraging consumption; right?

Mr. JOHNSON. I would want to change the balance. I think right now we have a bias against saving in the tax system. And so, yes, I would want to certainly reduce the tax bias against saving, and treat the decision between consumption and saving more neutrally.

But at the same time, I think that we should not add to the deficit in that process, and that if we are going to cut taxes on saving and that causes revenue loss, we should make it up by cutting spending.

Senator SARBANES. Or increasing taxes on consumption?

Mr. JOHNSON. Well, I personally do not think it would be helpful to see the overall tax burden rise. So my preference would be to see spending come down with the revenue decline—if there were such a thing. You could shift the tax base.

Senator SARBANES. Your proposal is to cut spending further, in order to cut taxes on savings, and not to affect the tax burden on consumption? Is that correct?

Mr. JOHNSON. Or you could shift the tax base from an income tax base to a consumed income tax base, and in a revenue-neutral way.

Senator SARBANES. How does the taxing on consumption in this country compare with other advanced industrial countries?

Mr. JOHNSON. We tax consumption I think a good bit less, certainly at the federal level.

Senator SARBANES. What are examples of that?

Mr. JOHNSON. Well, most other industrial countries have a value-added tax, or some other form of consumption-based tax, except for Switzerland I think, whereas we do not. Of course, the states have sales taxes at the state levels. And in fact we tax corporate earnings as well as dividend distributions, and we tax income when it is earned and the income from savings.

And so we certainly have a tax bias against saving relative to consumption. In the past, we have even allowed large deductions on interest payments for borrowed funds for consumption purposes.

All of these factors I think contribute to increasing the imbalance between saving and investment.

Senator SARBANES. How do our tax levels, for instance on gasoline, compare with other industrial countries? Do you know?

Mr. JOHNSON. Our tax rates I think on gasoline are substantially less than other industrial countries.

Senator SARBANES. And how about our tax rates on income?

Mr. JOHNSON. Our tax rates on income I think are probably comparable, maybe even higher in some cases. Although recently, with the reduction, in rates with tax reform and the previous tax rate reductions, I would say that at least in terms of top tax rates we have a more comparable if not competitive system with the income tax.

Senator SARBANES. Well, if you could submit something—it was my understanding that with the cuts that were made, that we are now one of the lowest of the advanced industrial countries.

Mr. JOHNSON. We are one of the lower ones now.

Senator SARBANES. Is that not correct?

Mr. JOHNSON. Yes, that is correct.

Senator SARBANES. Why did the Fed work at cross purposes with the Treasury in early October, with respect to the effort to lower the value of the dollar flowing out of the G–7 finance ministers' agreement just prior to the IMF meetings?

Mr. JOHNSON. Well, I think that the G–7 communique implied, in the language of the communique, that it thought that the dollar was a little out of line with the fundamentals, and that there would be coordinated efforts to resist further upward pressure on the dollar and avoid a sharp decline in the dollar.

I think that the concerns that I and others had at the Federal Reserve was not with the communique language, but was with the actual practice of heavy interventions to actually drive the dollar lower against the perceived fundamentals in the market place; rather than the kind of orderly intervention to resist upward pressure on the dollar, or stabilize the dollar, as has been the policy in the past.

So I and other members of the Federal Reserve made a sharp distinction between that type of intervention to actually try to drive the dollar down against market fundamentals, versus intervention to try and stabilize the dollar or avoid disorderly conditions in terms of its upward movement.

Senator SARBANES. Well, now, Germany and Japan had raised their interest rates, is that right, at the time?

Mr. JOHNSON. At that time I think Germany had—no, they had not.

Senator SARBANES. Which time are we talking about?

Mr. JOHNSON. Oh, I am sorry. It is October, you are talking about. I thought you were referring to the G–7 meeting.

Senator SARBANES. No, subsequent to the G–7 meeting. They moved fairly promptly to raise their interest rates; did they not?

Mr. JOHNSON. Well, they moved after the G–7 meeting.

Senator SARBANES. Right. Subsequent to it. Is that correct?

Mr. JOHNSON. Well, Germany and Japan both raised their interest rates after the G–7 meeting.

Senator SARBANES. Yes, subsequent to the meeting.

Mr. JOHNSON. Yes.

Senator SARBANES. OK. The Fed did not move to lower its interest rates at that point; is that right?

Mr. JOHNSON. Well, the Federal Reserve has lowered rates——

Senator SARBANES. At that point.

Mr. JOHNSON. Well, you mean at precisely the moment that Germany and Japan did?

Senator SARBANES. At, or roughly at the time that they did so.

Mr. JOHNSON. Well, they both moved separately themselves. And it is true, yes, the Federal Reserve did not lower rates at precisely the same time.

Senator SARBANES. So you not only did not participate in the interest rate movement, but as I understand it, also took the view that you should in effect block the Treasury's effort along with other governments to intervene in the financial markets. Is that correct?

Mr. JOHNSON. No, we have never made an attempt to avoid or block intervention when it was of a nature to smooth markets and avoid disorderly conditions, or to try and stabilize activity.

Senator SARBANES. Well, let's eliminate all of the qualifiers. In this instance, the Treasury was seeking to sell dollars in order to move the currency downward. Is that not correct?

Mr. JOHNSON. That is correct.

Senator SARBANES. And you all thought that they should not be doing that.

Mr. JOHNSON. That is correct.

Senator SARBANES. So you not only in effect cut counter to what the G–7 was trying to do with respect to your position on an interest rate adjustment, you also cut counter to it with respect to your position on the Treasury selling dollars in the exchange markets.

Mr. JOHNSON. Well, I would disagree with that characterization. Certainly, interest rates have been trending down in the United States, and trending up abroad in other industrial countries.

But I want to make it clear that the reasons for those interest rate movements have nothing to do with precise manipulations of the exchange rate. As I said in my statement, the major purpose of the G–7 is not to manipulate exchange rates, it is to ensure non-inflationary growth in the industrial world.

To do that, central banks feel very strongly that policy, interest rate and monetary policy, should be focused on stability of domestic conditions in each country, and that it is not very often when domestic conditions in each country are moving in such a precise, timely direction that interest rates can change simultaneously in each country in a way that can be as sensitive to the exchange rate as we might like.

So the fact of the matter is, with Japan, Germany, and the United States, each country's interest rates moved on the basis of perceived inflationary conditions in each of those countries and other factors in terms of the stability of financial markets and sustained growth.

And that is the reason for the difference in timing on interest rate adjustments, because that is the major focus of monetary policy in each country.

In terms of intervention, it is true that there were some modest disagreements over the technical nature of intervention, but I want to stress again—and I think Under Secretary Mulford made this point, and I agree with him—that in general, exchange rate policy coordination between the Treasury and the Fed has been working smoothly, and in fact is probably as smooth or more smooth than in times past.

Even though we have had disagreements from time to time on the technical nature of intervention, and there will continue to be so, I am sure, in the future, that is a healthy part of the process. I think if we all agreed on every single thing, we would not have the kind of healthy dialogue that we need to make this process work.

So it is true, there was some disagreement over the technical nature in which we would pursue intervention. But I do not think that that detracted dramatically from the overall direction of coordination, which we support completely.

Senator SARBANES. What do you think of the view expressed by some that the decline in the dollar value was much less than it would have been, had the Fed not had this problem over the intervention in currency, and had the Fed moved sooner on interest rates?

Mr. JOHNSON. Well, I think there is a legitimate question about whether the dollar needs to depreciate at all.

I think that, as I pointed out in my statement——

Senator SARBANES. How much concern do you have about this trade imbalance?

Mr. JOHNSON. Well, I have a good deal of concern about it. But the fact is that——

Senator SARBANES. What do you see as the implications of the United States now running a deficit on the investment account? Which took place, I gather, for the first time in the last quarter.

Mr. JOHNSON. Yes, I think that is true. Although some of that was due to exchange rate losses, I believe, rather than the income flows on various investment positions.

Senator SARBANES. Well, even if that is the case, we will soon be at a point where you will not be able to make that qualifier; won't we?

Mr. JOHNSON. Well, probably.

Senator SARBANES. Pretty quickly, if we are not there already.

Mr. JOHNSON. Possibly. Yes.

Senator SARBANES. I mean, if you run another $125 billion trade deficit this year, and let's assume it improves and we run $100 billion next year, and so forth, we will have crossed that line in any event; will we not? Then, we will be in the position that the investment account will be adding to our current account deficit, rather than helping to offset it.

Mr. JOHNSON. Well, that may be true, and that is why——

Senator SARBANES. What do you see as the implications of that for the United States?

Mr. JOHNSON. Well, I think it all depends on what the borrowed funds are used for. It is just like any household account, for that matter. If borrowed funds or the inflow of capital to the United States is put to good use, that generates a rate of return that allows the investment to service the principal and interest payments, plus earn a profit, it is financeable, and the sustainability of its financing is ensured.

Senator SARBANES. Well, that is—yes. What do you think the implications are of the world's most highly developed economy and the world's leading power being a debtor nation, rather than a creditor nation?

Mr. JOHNSON. Well, once again, as I said in my statement, I think that as long as we run the kind of saving-investment imbalance that we are running worldwide, we are going to continue to run trade deficits and have a growing external debt.

However, I think that it is pretty clear that the trade deficit has been trending down, and will continue to trend down. But at some point, I think it will probably stabilize, because of this saving-investment imbalance.

Senator SARBANES. At what point do you think that will be?

Mr. JOHNSON. I really do not have any idea. That depends on how quickly we solve our budget deficit problems in the United States and how quickly our domestic saving potential can increase, versus the internal investment decisions of surplus countries abroad.

If Japan refocuses a lot of its investment towards internal investment or developing countries, and the United States builds up its domestic saving and cuts the budget deficit, I think we can get the deficit down much faster. The longer that takes, the slower the process will be.

Senator SARBANES. I take it, though, that you are not troubled, just in any sort of fundamental way, as I am listening to you, by the United States having moved from being a creditor to being a debtor nation?

Mr. JOHNSON. Well, I am concerned if the funds that are the source of that debt are misused or misallocated in ways that do not yield significant returns on investment. And I think the deficit is one of the problems.

Senator SARBANES. Let's grant your premise. Then, you would have no concern; is that right?

Mr. JOHNSON. I would be less concerned. I think that there are political ramifications from this, but as far as being——

Senator SARBANES. So in other words, we would go back to being a developing nation as we were in the 19th century, and the fact that there was an inflow of capital into this country, as long as we put it to productive use—in your view there would be no problem then connected with that?

Mr. JOHNSON. Not necessarily.

Senator SARBANES. I mean, wouldn't there be a problem in our leadership role internationally, politically?

Mr. JOHNSON. Well, it would all depend. I mean, if we are still making large investments abroad, if the developing countries develop sound economic policies that open their countries up for private capital investment——

Senator SARBANES. Would there be a capital net flow into those countries, or a capital net outflow from those developing countries?

Mr. JOHNSON. From developing nations?

Senator SARBANES. Yes.

Mr. JOHNSON. Well, I think that that depends on the policies they develop.

Senator SARBANES. Well, what is desirable, as you would see it?

Mr. JOHNSON. Well, I think that over time they need continued capital inflows, if they are going to——

Senator SARBANES. They need a capital inflow. Now, if the developing countries need a capital inflow, where is it going to come from, if the developed countries are also going to have a capital inflow, which I take it was your premise about the United States?

Mr. JOHNSON. Well, there may be a capital inflow into the United States There are other surplus countries, and their capital investments may flow both to the United States and to developing nations as well.

Senator SARBANES. Now, if that is the situation, what are the implications of that for the U.S.'s leadership position?

Mr. JOHNSON. Well, once again, I do not think it necessarily damages our leadership position, unless we squander those resources. Then, I think that we will be a weak economy, and our position in terms of leadership from economic strength will be severely damaged.

Senator SARBANES. You do not think that there will be some shift in leadership towards the countries whose economies are sufficiently strong that they can provide capital, rather than drawing in capital?

Mr. JOHNSON. I think the best of all worlds would be that we certainly improve our international capital position by building up our own domestic savings and capital formation, by cutting the budget deficit, and increasing domestic savings.

We would be much better off if we would do that.

Senator SARBANES. I wanted to ask you about this assertion in your statement—and we are going to have to draw to a close here shortly—that "* * * in present circumstances, with the U.S. economy pressing on capacity constraints * * *"—I understood that earlier this week, the Federal Reserve released data that showed that capacity utilization fell again in October.

Mr. JOHNSON. That's correct.

Senator SARBANES. To under 83 percent, which I understand is the lowest level in a 1½ years, in 18 months. Is that right?

Mr. JOHNSON. That is true.

Senator SARBANES. Now, on the basis of that development, I would like an explanation of this assertion that we are pressing on capacity constraints, and therefore " * * * there is little room for substantial further reduction in U.S. external deficits * * *".

Mr. JOHNSON. The point was that the U.S. economy has been consistently expanding for seven full years, the longest peace-time expansion period in our history. And for the last——

Senator SARBANES. The longest, in terms of time?

Mr. JOHNSON. Time.

Senator SARBANES. Not necessarily in terms of the degree of expansion or quantity of expansion. It does not necessarily compare that well with other expansions; would that be correct?

Mr. JOHNSON. Well, if you mean there have been other expansions that had rapid overheating and grew very, very rapidly in the first two years, and reached capacity constraints and inflationary pressures. And certainly there was a more rapid growth of GNP during that period; but not necessarily more productive in the long run.

I think over the whole period of this expansion that the amount of GNP and income growth has been very substantial, compared to other expansions.

Senator SARBANES. Well, I have seen comparisons—and you can argue about slow-but-steady as being better than quick-but-somewhat-erratic—but I have seen comparisons that have taken an expansion, taken the downturn, taken the subsequent expansion, over a period of time, and have said, well the degree of expansion was significantly greater than what has occurred over these seven years.

First of all, do you take sharp difference with that observation?

Mr. JOHNSON. I honestly am not sure. I mean, I would have to study it. I am not sure exactly what measure you are using.

Senator SARBANES. Well, that may not be the best way to do it. You know, I am prepared to look at it. But I think that there is some view, as I understand it, that while we have had a continuous expansion, it has been very slow, and therefore the extent we have moved upwards has been less.

Mr. JOHNSON. I do not think that is the case. I would disagree. I think that the average growth rate over the seven years is probably something just under 4 percent, which is about the average with other expansions, except for the fact that this expansion is much longer. So the total growth of GNP I think is significantly higher than any other peace-time expansion period.

Now, the 1960's was a longer expansion period. It is not considered a peace-time expansion, because of the VietNam war build-up. But I think next to that particular one, this one would be second, in terms of level of GNP ultimately, and certainly the average growth rate, while maybe slower than some other expansion periods, is about average with expansion periods but has stretched out much longer. So I would think that would be very positive.

Senator SARBANES. Yes. Of course, we had a very big military build-up during this period, even though we did not actually have a war.

Mr. JOHNSON. That is true.

Senator SARBANES. So a good deal of this expansion was fueled by military spending, even though there was not a war being fought.

Well, what about this capacity situation? I mean, isn't there sufficient room to expand, reduce our external deficits on the basis—do you think we are up against a capacity constraint?

Mr. JOHNSON. Well, I honestly do not know exactly where that threshold is. And I think anybody that says they know precisely is incorrect.

Senator SARBANES. I do not quarrel with that. But then, how can you make this statement, when the figure is at the lowest point it as been at for 18 months?

Mr. JOHNSON. Well, I think that the point that I am trying to make is that the economy has been growing for seven full years, the unemployment rate is down to—not the lowest rates that we have ever had in our history, but near rates that people consider to be close to the full employment rate of unemployment.

And our growth rate has continued to grow around ranges that people consider to be close to potential, and even some people would say it is above our potential growth possibilities.

The simple fact is that we do not know precisely where that threshold is; but one symptom of an expansion that is getting very mature and an economy close to its capacity constraints is the beginnings of overheating pressures, or inflationary pressure build-ups. And in fact we have seen inflationary pressures, in 1987 and 1988, and early 1989, which we think were symptomatic of an economy straining itself.

And so because of that, we have pursued more restrained policy up until the early summer of this year. Since that time, as we have seen capacity utilization ease a little, and some of the growth in

domestic demand slow down, we have pursued a modest easing of interest rates which we think helped balance the economic situation and allowed the economy to continue growing and making progress on the inflation pressure at the same time.

So you are right. There has been some sign of slowing more recently, and we have tried to respond to that in a cautious way, to avoid a resurgence of inflationary pressure, but trying to be sensitive enough to real growth to continue to sustain the economy, but to make progress on inflation at the same time.

Senator SARBANES. Well, let me put this question to you.

I notice that in your statement today on page 3, which tracked your statement before the House Banking Committee a couple of weeks ago——

Mr. JOHNSON. Yes.

Senator SARBANES [continuing]. But you did switch from saying "there is little room." You said today "there is less room."

Mr. JOHNSON. Yes.

Senator SARBANES. I take it, that——

Mr. JOHNSON. That was a modest attempt to be sensitive to your point.

Senator SARBANES. All right.

I simply want to close the hearing by saying, we had Professor Friedman before us yesterday—Tuesday. In his book, he says the following, and it really goes to the point we spent a good deal of time on this morning:

> World power and influence have historically accrued to creditor nations. It is not coincidental that America emerged as a world power simultaneously with our transformation from a debtor nation dependent on foreign capital for our initial industrialization, to a creditor supplying investment capital to the rest of the world. But we are now a debtor nation again, and our future role in world affairs is in question. America's influence over nations and events will ebb.

That is really the point I was trying to get across.

Mr. JOHNSON. Yes.

Senator SARBANES. We thank you very much for being with us this morning.

Mr. JOHNSON. Thank you, Mr. Chairman.

Senator SARBANES. The hearing is adjourned.

[Whereupon, at 12 p.m., the subcommittee hearing was adjourned.]

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

January 25, 1990

The Honorable Paul S. Sarbanes
Chairman, Subcommittee on
International Finance and
Monetary Policy
United States Senate
Washington, D.C. 20510

Dear Senator Sarbanes: Paul

Enclosed are answers you recently requested on questions pertaining to my testimony before the Subcommittee on International Finance and Monetary Policy on November 16, 1989.

Sincerely,

David C. Mulford
Under Secretary
International Affairs

Enclosures

Question: In your view, what circumstances justify exchange market intervention? How successful has it been in the past?

Answer:

Intervention is justified if an exchange rate is excessively low or high in the context of the present and expected development of fundamental economic variables. In addition, however, there needs to be general agreement on these matters among the countries whose currencies are involved in intervention.

We have been largely satisfied with the results of intervention, which we see as a complement to cooperation with our principal partners on broad economic policies.

Question: How costly is exchange market intervention? Have the Treasury and the Federal Reserve made or lost money on transactions this year, counting both realized and accrued gains and losses?

Answer:

As shown in the attached tables, both the Treasury and the Federal Reserve have made profits on foreign exchange holdings and transactions over time. Data for Calendar 1989 are not yet available.

For the first three quarters of 1989, the first table shows that Treasury had a loss of $584 million, taking into account both realized and unrealized gains and losses. The loss reflects the appreciation of the dollar during this period from the relatively low levels prevailing at the end of 1988, which resulted in unrealized losses on the holdings of foreign currencies that were not fully offset by realized gains, and should be seen against the very substantial gains occurring in 1986 and 1987, when the dollar declined significantly. Because the dollar on balance declined in the final quarter of 1989, there should be a gain during that quarter which will offset part of the loss registered in the first three quarters.

EXCHANGE STABILIZATION FUND (ESF)
MEASUREMENTS OF NET INCOME AND IMPACT ON THE FEDERAL BUDGET

(millions of dollars)

	ESF NET INCOME*				BUDGET IMPACT:~	*Note:* Realized Gain(loss) on Foreign Currency	
	Gain(loss)^ on.....			*Total:*	Negative Net Outlay		
Calendar Year	Foreign Currency	SDRs	Interest	Net Income	(Reduces budget deficit)	ESF	Federal Reserve
1980	(31.3)	42.0	534.1	546.1	NA	42.8	24.6
1981	(516.1)	213.9	533.0	230.5	NA	(4.5)	4.9
1982	52.8	86.1	498.5	637.4	NA	19.4	0.0
1983	62.8	(14.4)	446.6	495.0	NA	(187.3) #	0.0
1984	(277.0)	(37.0)	502.4	188.4	NA	(21.4)	(17.7)
1985	990.5	178.1	465.9	1,635.2	NA	0.0	0.0
1986	1,565.3	109.1	645.3	2,319.7	NA	0.0	0.0
1987	1,516.7	416.0	560.7	2,493.4	2,217.7	1,360.1	1,139.1
1988	(236.7)	(162.5)	664.7	265.5	876.6	401.4	610.3
1989:Q1-Q3	(584.0)	(158.2)	696.2	(45.9)	663.9	148.8	0.0
Fiscal Year							
FY1980	91.9	3.8	490.9	587.7	481.5	66.7	(9.1)
FY1981	(1,171.7)	283.8	558.2	(330.0)	801.5	(7.6)	11.1
FY1982	(32.2)	63.6	464.3	495.7	527.7	15.1	0.0
FY1983	613.5	(13.3)	489.9	1,090.1	517.6	21.8	0.0
FY1984	(245.9)	(31.3)	490.5	213.2	246.0	(226.2) #	(17.7)
FY1985	477.2	96.6	469.1	1,043.7	556.7	0.0	0.0
FY1986	1,925.6	145.7	642.3	2,713.6	771.9	0.0	0.0
FY1987	618.0	125.0	533.5	1,276.5	1,410.1	754.5	845.7
FY1988	212.1	37.8	630.0	879.8	1,498.5	851.5	748.0
FY1989	(38.6)	(38.1)	884.4	807.7	1,118.7	304.2	155.3

* Accrual basis

~ Cash basis

^ Includes both realized and unrealized gains(losses).

\# ESF loss (of $204.8 million) in 1983:Q4 reflects sale of currencies to fund subscription payment to IMF.

Sources: Treasury Bulletin (Table ESF-2)
Monthly Treasury Statement (Table Outlays of the U.S. Government)
The Budget for Fiscal Year 19__ (under Department of the Treasury, Public Enterprise Funds)
Federal Reserve Bank of New York Quarterly Review (Treasury and Federal Reserve Foreign Exchange Operations)

FEDERAL RESERVE

MEASUREMENTS OF NET INCOME ON FOREIGN CURRENCY AND IMPACT ON THE FEDERAL BUDGET

(millions of dollars)

	NET INCOME ON FOREIGN CURRENCY HOLDINGS			TOTAL NET INCOME	BUDGET IMPACT:	*Note:*
Year	Gain(loss)^	Interest	Total	(before payment to U.S. Treasury)	Payments to U.S. Treasury	Realized Gain(loss) on Foreign Currency
1980	96.1	123.4	219.5	11,833.5	11,706.4	24.6
1981	(306.0)	577.4	271.4	14,175.2	14,023.7	4.9
1982	(149.6)	432.5	282.9	15,362.3	15,204.6	0.0
1983	(456.3)	273.8	(182.5)	14,420.6	14,228.8	0.0
1984	(454.8)	217.1	(237.7)	16,308.7	16,054.1	(17.7)
1985	1,210.0	228.7	1,438.7	18,054.7	17,796.5	0.0
1986	1,971.0	393.6	2,364.6	18,005.1	17,803.5	0.0
1987	1,804.3	343.9	2,148.2	18,030.2	17,738.9	1,139.1
1988	(510.9)	299.8	(211.0)	17,554.9	17,364.3	610.3
1989	NA	NA	NA	NA	NA	0.0

^ Includes both realized and unrealized gains(losses).

Sources: Annual Report of the Board of Governors of the Federal Reserve System
Federal Reserve Bank of New York Quarterly Review (Treasury and Federal Reserve Foreign Exchange Operations)

Question:

If our current account balance falls substantially without any real progress on the budget deficit, what are the consequences for capital formation and productivity growth in this country?

Answer:

As indicated in the Exchange Rate Report, the trade and current account deficits have declined substantially from their 1987 peaks. This reflects primarily a combination of exchange rate effects, stronger growth in major trading partners (notably Japan and Western Europe) and a moderation of U.S. demand growth accompanied by some improvement in U.S. saving performance.

The budget deficit also has declined substantially, from 5.3% of GNP in FY86 to 3.0% in FY89. Private saving also has rebounded somewhat from lows of several years ago. Improving U.S. saving performance -- public and/or private -- allows us to sustain high levels of investment, without the need to continue the heavy foreign borrowing which is the miror-image of our current account deficit.

We are concerned that the process of reducing our trade and current account deficits continue. However, this cannot be a sole or overriding goal of U.S. policy. We also want sustained, non-inflationary growth in output and employment. A major slowdown or recession in the U.S. would help our trade position, but the improvement would be transitory if it leads to a recession abroad. Given the size of the U.S. market, a U.S. recession very likely would spread to our trading partners, leaving everyone worse off.

However, U.S. recession, or major slowdown, would be one development which could produce a decline in the current account deficit without further progress on the budget deficit. A recession would likely be accompanied by a weakening in U.S. investment performance, with negative effects on future productivity growth and living standards.

On the other hand, a further improvement in private saving performance could contribute to the same divergent behavior of the budget and current account deficits, without the negative effects on U.S. investment.

As you know, our ongoing budget deficit reduction efforts, which require close cooperation between the Administration and Congress, represent the single most important contribution we can make to improving national saving performance. In addition, the Administration is actively looking for ways to strengthen U.S. private saving and to reduce cost of capital to U.S. firms, as other important avenues to improve overall U.S. economic performance.

Budget deficit reduction also is our major contribution to a coordinated approach with other countries which recognizes that the responsibility for sustaining world growth with low inflation and reduction of external imbalances is the responsibility of both surplus and deficit nations.

12/11/89

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

MANUEL H. JOHNSON
VICE CHAIRMAN

December 26, 1989

The Honorable Paul S. Sarbanes
Chairman
Subcommittee on International Finance
and Monetary Policy
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am enclosing responses to the written follow-up questions that you sent on behalf of Senator Riegle regarding my testimony on November 16, 1989 on exchange rates. If I can be of further assistance, please let me know.

Sincerely,

Manuel H. Johnson

Enclosure

Vice Chairman Johnson subsequently submitted the following in response to written questions from Senator Donald W. Riegle, Jr., in connection with the hearing held on November 16, 1989:

Question 1: In your view, what circumstances justify exchange market intervention? How successful has it been in the past?

Answer: Intervention operations in foreign currencies have generally been directed at countering disorderly market conditions. The concept of countering disorderly markets is not easily defined. It relates most clearly to circumstances of excessive short-term volatility in exchange markets, as evidenced, for example, by widening bid-asked spreads. It also embraces operations to counter excessive speculation, market dynamics, or other short-term phenomena that might temporarily overwhelm the effects of underlying economic fundamentals and, thereby, to restore market conditions that would be more likely to permit the underlying economic fundamentals to reassert themselves.

When measured in terms of these objectives, intervention in exchange markets has been modestly successful in the past. It has helped to smooth some short-term disturbances and, when accompanied by appropriate and complementary economic policy actions in the United States and abroad, has helped to focus the attention of market participants on the underlying economic fundamentals. However, it cannot move exchange rates permanently or significantly against those fundamentals, nor can it be used successfully as a substitute for needed policy actions.

Question 2: How costly is exchange market intervention? Have the Treasury and the Federal Reserve made or lost money on transactions this year, counting both realized and accrued gains and losses?

Answer: Through mid-December the Federal Reserve has accrued unrealized gains on its foreign exchange holdings of approximately $850 million during calendar 1989. It has realized no profits or losses this year.

The Treasury's Exchange Stabilization Fund (ESF) has accrued unrealized gains of approximately $500 million. The ESF also realized a gain of nearly $200 million. This realization of previously unrealized gains occurred when the ESF sold foreign currencies spot to the Federal Reserve under the warehousing agreement. These warehousing transactions, whereby the ESF sells foreign currency bought against forward repurchases with the Federal Reserve, were undertaken to replenish ESF dollar resources to allow it to continue to intervene equally with the Federal Reserve.

Question 3: If our current account balance falls substantially without any real progress on the budget deficit, what are the consequences for capital formation and productivity growth in this country?

Answer: A significant reduction in the U.S. current account deficit without any progress on the budget deficit would most likely lead to a reduction in the rate of U.S. private capital formation, with potentially negative consequences for U.S. productivity growth. The fundamental accounting identity between savings and investment in the economy requires that if the inflow of saving from abroad declines (i.e., the current account deficit falls), then either domestic saving (i.e., either the government budget or private saving) must rise or domestic investment must fall.

An event that one often associates with a potential reduction in the U.S. external deficit is a reduced willingness of international investors to accumulate additional claims on the United States. In this event, the dollar would depreciate, which would tend to stimulate net exports and reduce the deficit. With the economy near full employment, and without any real progress on the budget deficit, a substantial depreciation of the dollar, and the associated rise in import prices and net exports, would put upward pressure on interest rates in order to bring savings and investment into balance. Unless either private saving or government saving rose, the rise in interest rates would crowd out domestic investment. A reduced rate of investment would result in a lower level of the capital stock and over

the longer run somewhat lower labor productivity than would otherwise be the case.

Question 4: You stated on page 3 of your prepared testimony that "the aim of negotiation in the G-7 is to achieve and to sustain the maximum long run growth of the world economy consistent with low inflation." Section 3003 of the Omnibus Trade bill, however, states that "the goal of the United States in international economic negotiations should be to achieve macroeconomic policies and exchange rates consistent with more appropriate and sustainable balances in trade and capital flows and to foster price stability in conjunction with economic growth."

Can you explain to us whether U.S. representatives at G-7 meetings are aiming to achieve the goals set out in the law, and if not, why not?

Answer: U.S. representatives at G-7 meetings are aiming to achieve the goals set out in the Omnibus Trade bill and in other legislation. Exchange rates and external balances are the key indicators of the compatibility across countries of macroeconomic and structural policies. By adjusting policies in a manner consistent with generally stable exchange rates and sustainable external positions, officials in G-7 countries are laying the groundwork for achieving the fundamental objective of sustaining maximum long-run growth of the world economy consistent with low inflation.

Question 5: You stated on page 2 of your prepared testimony that any strategy to reduce our trade deficit must focus on policies to increase the U.S. saving rate including cutting our budget deficit.

In your view are America's budget and trade deficits and growing foreign investment in our economy necessarily inter-related? If so, please explain how.

Answer: The budget and trade deficits are inter-related within the overall identity between saving and investment in the economy. That accounting identity requires that domestic investment can be no more or less than the sum of total saving by the private sector and the government, plus the net inflow of saving (or funds that are invested) from abroad. If domestic investment were exactly equal to private domestic saving, government dissaving (or the budget deficit) would be exactly equal to the inflow of foreign saving (which is the counterpart of the trade deficit, or more precisely, the current account deficit). And, so long as that relationship between private saving and investment remained unchanged, movements in the budget deficit would be exactly reflected in movements in the current account deficit.

Over the past two decades there have been several episodes when the budget deficit and the current account deficit have moved fairly closely together. Most notable has been the period since 1982. The shift in fiscal policy underlying the widening of the budget deficit over the first half of the 1980s contributed to a higher level of real interest rates in the United States than would otherwise have prevailed. The resulting increased attractiveness to international investors of financial investments in the United

States contributed to the rise in the foreign exchange value of the dollar, which in turn, led to a decline in U.S. price competitiveness and a deterioration of the trade balance. In more recent years, the budget deficit has been trending down, U.S. real interest rates and the dollar have declined and the external deficit has receded.

Of course, the relationship between the two deficits, even during this period, has been far from exact. A downtrend in the private savings rate, at a time when the rate of private investment has remained little changed, also appears to have contributed to the widening of the external deficit during the 1980s. Nevertheless, it seems unavoidable that significant further progress in reducing the external deficit (without depressing investment to unacceptably low levels) will have to involve a substantial reduction in deficit spending.